

51809

September, 2009

Nepal Economic Update



*Economic Policy and Poverty Team
South Asia Region*

The World Bank

Summary — An Economy Kept Afloat by Remittances

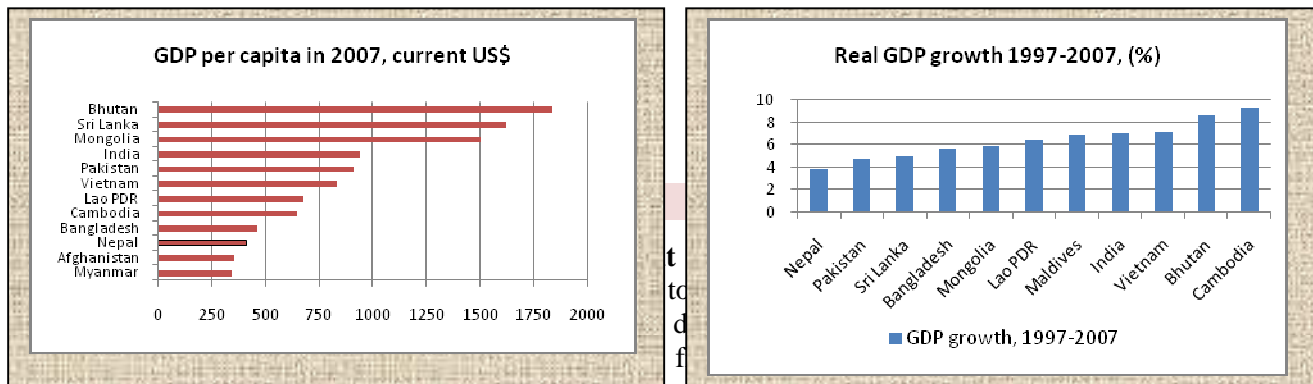
- *Political uncertainties persist as standoff continues between the 22-party coalition government and the main opposition Maoist party. Continued labor union unrest affects industry adversely.*
- *Growth in FY09 was 4.7 percent, led by the service sector's high growth. Industry and agriculture grew by only 2 percent.*
- *Strong service sector growth was based mainly on high consumption demand because of massive remittances from workers abroad—estimated to be near 30 percent of GDP.*
- *Inflation remains high, at 11 percent (12 months), because of security-related supply bottlenecks, cartel activities and from liquidity built up from remittances. Large and rapid government spending at the end of FY09 also served to prolong high inflation. The Nepali rupee is pegged to the Indian rupees. However, inflation pressures are building up in India, due to renewed rise in price of primary products, which may add to the inflationary pressures in Nepal.*
- *Nepal seems to have suffered little harm from the global financial crisis—tourist arrivals were down marginally in FY09, but remittances continue to grow strongly.*
- *High remittance inflows are creating strong demand for real estate, and average prices are rising rapidly promoting widespread speculative behavior. Observers are concerned that there is an asset bubble and that a soft landing may be hard to engineer.*

¹ This report was prepared by Hisanobu Shishido, Roshan Darshan Bajracharya and Ceren Ozer.

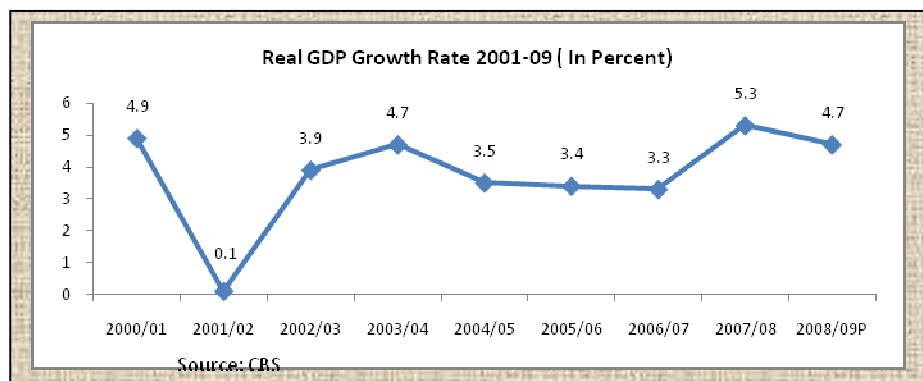
Recent Developments

Real Sector

Nepal remains among the poorest countries in the world with per capita income at US \$470 (2009) - and growing slowly. Charts below show GDP per capita, and real GDP growth in the past decade have been among the lowest in a sample of comparable Asian economies.



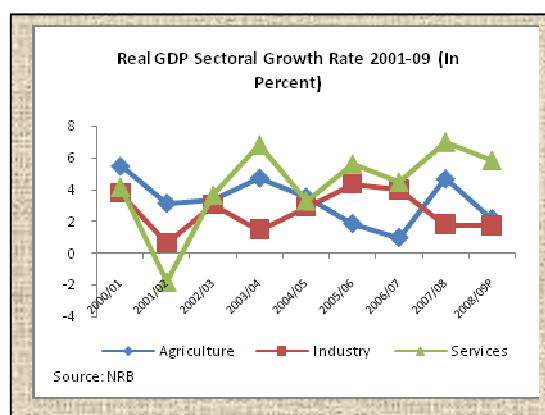
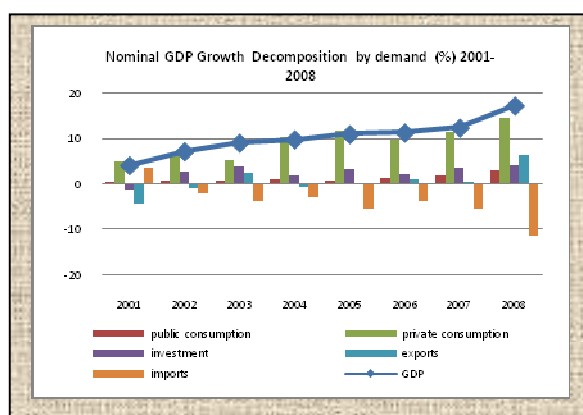
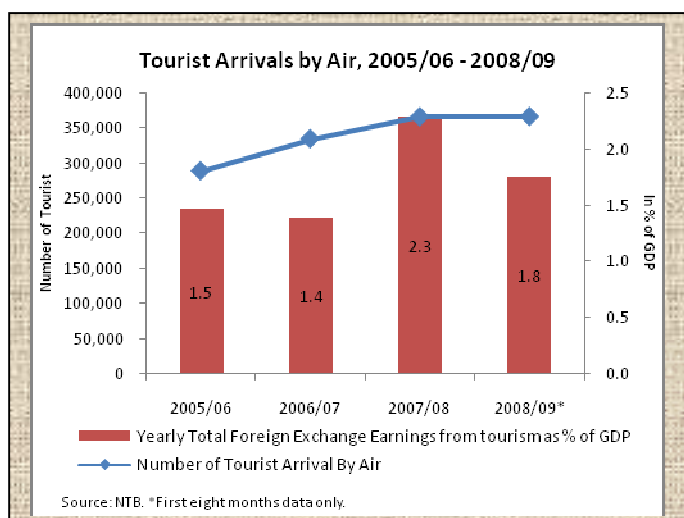
agricultural growth (to 4.7 percent) and increased tourist arrivals contributed to this growth. With less timely rain, however, aggregate economic growth reverted to 4.7 percent in 2008/09. The industrial sector is stagnant; it has grown at a low 1.8 percent a year for the last two years and is hampering GDP growth. The service sector is the only sector consistently contributing to growth—it grew by 7 percent in 2007/08 and 5.8 percent in 2008/09—and its share of GDP has increased from 43.6 percent in 2001/02 to 47 percent in the most recent estimate. The high remittance inflows and associated increase in consumption have contributed mainly to the high service sector growth.



Over the last decade, the service sector has grown rapidly while agriculture and industry, as a share of GDP, has declined. Average growth of the service sector over the last decade was 4.4 percent while agriculture and industry grew by 3.1 and 2.5 percent respectively. Wholesale and retail trade, transport, financial intermediation, and, more recently, real estate led the service sector's growth. Industrial growth declined from 9 percent, during the first half of the 1990s, to 6 percent in the second half of the 1990s, to around 2 percent in the 2000s. Manufacturing performance is particularly poor as the sector faces many constraints, including weak governance and political uncertainties; law and order problems and activities of militant laborers, including strategic road blockades by politically aligned militias; infrastructure bottlenecks, in particular, roads connectivity to markets and power shortages (daily blackouts of up to 18 hours); labor regulations which make hiring and firing difficult; rising real wages of

unskilled workers (due in part to a rise in minimum wages); and increasing production costs vis-à-vis foreign competitors (Nepal Investment Climate Survey, forthcoming).

Tourism has good potential, but its contribution to growth is still low. Its share of GDP, as measured by the value added by hotels and restaurants, remains below 2 percent. While its indirect effects on GDP, which are not captured by statistics, must be significantly higher, foreign exchange earnings of the sector are also around 2 percent of GDP. Tourist arrivals plummeted in 2001/02 when major internal fighting broke out. Over the last several years, the sector has been recovering slowly, and, with the successful conclusion of the peace agreement, arrivals increased further in FY08. However, deteriorated law and order conditions, political uncertainties and ongoing global financial troubles seem to have put a damper on tourism in FY09 arrivals declined marginally by 2 percent. Observers attribute the small size of the adverse impact to the niche nature of Nepal as a destination for mainly budget travelers and trekkers—which, they say, are probably less affected by the global financial crisis or political uncertainties than high-end travelers. During 2008, about 500,000 tourists visited Nepal, of which, one-quarter came from Europe, 8.4 percent from North America and 5 percent from Japan. Visitors from India and Sri Lanka made up 18 percent and 7 percent of the total.



Regarding expenditures in the National Accounts, the growth driver has largely been private consumption, which is increasing rapidly with high remittance flows. Also, in 2008/09, public consumption amply contributed to this growth.²

² However, data on expenditure are very weak as they are usually estimated on the basis of outdated or small-sample surveys. “Changes in stock” is the residual, which increased recently to 8-11 percent of GDP, which is much higher than levels seen in other countries in the region (1-4 percent). If we use data in the Nepal Living Standards Survey of 2003/04, as the basis for projection, current consumption may well be underestimated in the national accounts, and the residual, change in stocks, overestimated. This is because, since that survey was published, officially-recorded remittances have increased from around \$800

Employment

Labor force participation rates for workers 15 years or older declined from 85.8 percent in 1998/99 to 83.4 percent in 2008 (Labor Force Survey 2008). A larger decline is seen in urban areas from 73.3 percent to 67.3 percent. It can be conjectured that both discouragement effects (there are not enough jobs available) and the fact that many can afford to be out of work due to high remittances are contributory factors. Urban labor force participation is comparable to the rates in other countries in the region but the rural rate in Nepal seems higher. Paid employees are 17 percent of the population, a percentage point increase from a decade ago. The proportion of economically active children (5-14 years old) declined from 40.9 to 33.9 percent of the cohort, indicating lessening but still significant child labor force participation.

Given slow growth and limited productive investment, underutilization of both labor and capital affects job creation. According to the 2008 Labor Force Survey, the average unemployment rate is low, at 2.1 percent. The rural unemployment rate is 1.2 percent, but urban unemployment is 7.5 percent. Underemployment (those working less than 40 hours a week while wishing to work more) is also high, at 7 percent of the economically-active population aged 15 years or above. This rate is highest at 8 percent for the age group 20-29.

Wages

Despite the relatively high rate of underemployment and underutilization of labor, wages for workers are rising rapidly. As of end - FY09, the average annual salary index and wage index were 20 percent above the levels 12 months earlier. In the public sector, civil service salaries increased by 28.1 percent in FY09 after an increase of 23.5 percent in FY08; army and police increased their salaries by 30.9 percent this year. Banking and financial institutions, with the presence of two large state-controlled banks and their influential unions, increased worker remuneration by 18.2 percent this year after an increase last year of 50.5 percent. Reflecting the stated government policies, the wage increases in these public institutions were higher at entry and lower levels than at senior levels. The wage index went up by about 20 percent for both agriculture and construction workers. Increase in agricultural wages may reflect labor scarcity as more and more workers are leaving rural areas for foreign employment. Part of the remittances these workers send home are, in turn, fueling the housing boom—which raises demand for construction workers. Industrial wages are growing less rapidly, probably reflecting the sector's low growth—but this increase (17 percent) is still above inflation (13.2 percent).

Table One: Increase in Wages and Salaries (as of end of Fiscal Year - Percent change)			
	2006/07	2007/08	2008/09
Civil services	10.0	23.5	28.1
Armed forces	11.4	9.3	30.9
Agricultural laborer	11.4	17.2	20.7
Industrial Laborer Unskilled	27.5	3.4	17.0
Construction laborer	10.3	7.8	20.1

This

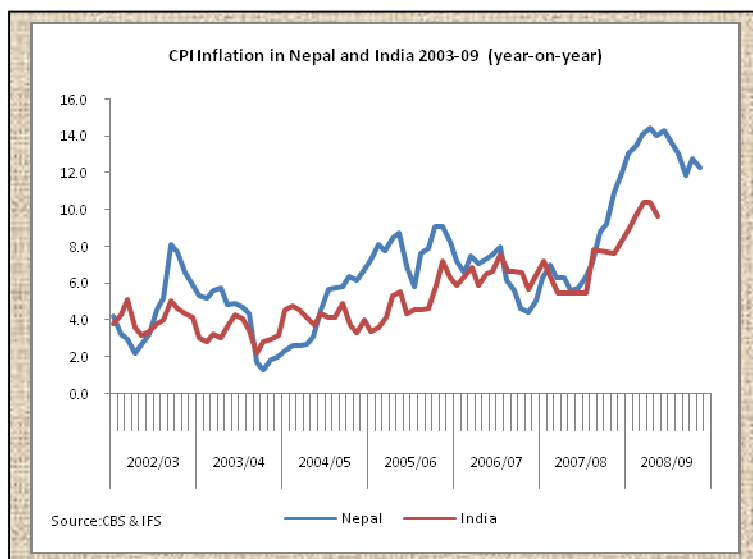
million to over \$2.7 billion. The decomposition chart (above) indicates a modified demand decomposition adjusting change in stocks to a historical average of 2-3 percent of GDP and adding the excess of stock change over the historical average to consumption.

rising trend of salaries and wages is corroborated by the recent Labor Force Survey 2008. The survey shows that wages in FY09 were 150 percent higher than in FY99, which implies an average annual increase of 10 percent, much above the average inflation rate over the decade.

Prices

Inflation remained high, at 11 percent in the 12 months to end of FY09—the highest in the region.

Average inflation for the fiscal year was 13 percent—up from around 5-6 percent until early 2008. Price movements continue to be closely linked to those of India, where the CPI has increased significantly in recent months. Rapid increases in international oil and, in particular, food prices started to push up inflation in Nepal from mid-2008. The rate exceeded 14 percent toward the end of the year. Since then, although international prices have come down, inflation remains high.



Items with the highest 12-month price increases are vegetables (70 percent), sugar and related products (60 percent), and meat products (32 percent). Non-food items started to show signs of stabilization as the overall non-food price index increased by only 2.7 percent over the 12 months to end FY 09—in particular, transport costs that had increased significantly over the last year started to decline.

The government attributes the high inflation to security-related supply bottlenecks, such as, roadblocks and strikes (bandh) as well as cartelling of key commodities (wheat, low-end rice, sugar, meat products, eggs, and transportation). But other factors have contributed: the high liquidity created by strong inflows of remittances; large wage increases in public sector; and a relaxation in fiscal policy starting in May 2009, when the new government managed to release funds quickly and spent NRs 18 Billion, equivalent to 1.8 percent of GDP in the course of two months³. The high and sudden spending, without monetary adjustment to offset it, appears to have contributed to reversing the declining trend of inflation—and raised the 12-month rate by a full percentage point from 11.9 percent in April to 12.9 percent in May 2009.

Fiscal Sector

Fiscal

The 22 - party coalition government presented its budget to the parliament on July 13, 2009. This was the first time the government has tabled a fiscal-year budget with a medium term expenditure framework (MTEF) and measurable indicators for parliament's approval. In presenting the budget, the government stated that its aims were to: (i) build consensus among all political parties; (ii) uphold constitutional supremacy; (iii) maintain rule of law; (iv) guarantee good governance; (v) finalize the peace process; (vi)

³ On May 8th, Treasury current balance – Rs. 22 Billion. On July 15th, 2009, end of fiscal year 2009, Treasury current balance – overdraft of Rs. 700 million.

promulgate a new constitution with national consensus; and, (vii) accelerate economic growth through state restructuring and socio-economic transformation. The budget recognizes that weak implementation, inflation and inadequate infrastructure are challenges to the economy while a deteriorating investment climate, energy crisis and poverty/inequality are challenges to growth.

The government of Nepal has been fiscally prudent – average net domestic borrowing is 1.3 percent of GDP (2005 - 2009). The Budget is expansionary but proposed domestic borrowing is within agreed limits. The proposed FY10 spending is 26.5 percent of GDP- an increase of 4.2 percentage points of GDP from the FY09 level.

Recurrent expenditure is 16.7 percent (inclusive of principal repayment) and capital expenditure 9.8 percent of GDP. This increase in budget expenditure is financed by domestic revenue of 16.3 percent of GDP (an increase of 1.5 percentage points of GDP over the FY09 performance); foreign financing of 7.3 percent of GDP (or an increase of 74

percent over the FY09 level); and gross domestic borrowing of 3 percent of GDP (or an increase of 17 percent over the FY09 level). Several policy announcements made after the introduction of the budget have cost-implications that could raise domestic borrowing above the current 3 percent of GDP⁴.

Public Expenditure (percent of GDP)						
	2005	2006	2007	2008	2009Est. outcome	2010 budget
Revenue	11.9	11.1	12.0	13.2	14.8	16.3
Current Expenditure	10.5	10.2	10.6	11.2	12.7	14.9
Capital Expenditure	4.6	4.5	5.5	6.5	7.6	9.8
Principal Repayment	2.3	2.2	2.3	2.0	1.9	1.8
Foreign Grant	2.4	2.1	2.2	2.5	3.6	5.3
Deficit Financing after grants	3.1	3.8	4.1	4.1	3.8	4.9
Foreign Loan	1.6	1.3	1.4	1.1	1.1	2.0
Domestic Borrowing	1.5	2.5	2.8	3.0	2.7	2.9
Net Domestic Borrowing	0.2	1.4	1.5	1.9	1.8	2.1
Total expenditure	17.40	16.95	18.35	19.71	22.25	26.5

Indirect taxes levied on consumption fuel revenue growth. In FY09, for the second year in a row, government's actual revenue collection exceeded the budget target by 24 percent. Tax reforms, improved efficiency of the Large Tax Payers' Office, introduction of an incentive package for revenue officials and a Voluntary

Revenue - Percent of Total Revenue				
	Year	2008	2009	2010
Tax revenue		79.1	82.3	85.2
Non tax revenue		18.4	15.0	12.6
Principal repayment by corporations		2.5	2.7	2.2
Trade tax		19.6	18.2	18.8
Vat		27.7	28.1	29.2
Excise		10.4	10.8	11.1
Income tax		17.7	19.4	20.6
Duty and fees		5.5	6.4	4.2
Sales of govt. property		1.2	0.9	1.0
Dividends		4.7	4.5	4.5
Royalty		5.4	2.1	1.9

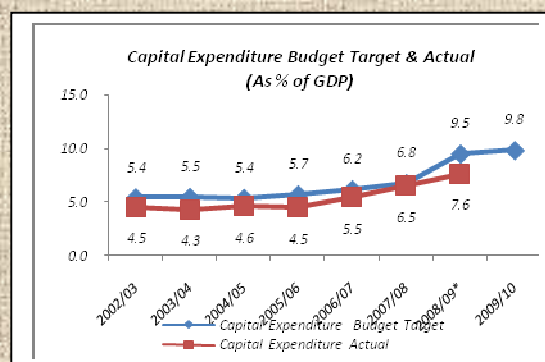
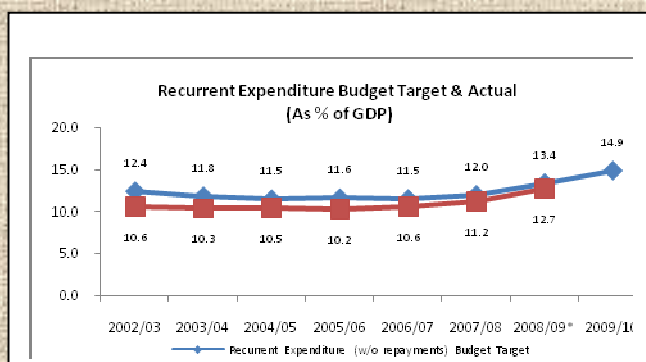
⁴ Post-Budget new announced activities includes – New Security Plan, Food-grain purchases and civil service salary increases.

Disclosure of Income Scheme have collectively contributed to this impressive achievement. Encouraged by the previous year's collections, the new budget aims to increase gross revenue collection by another 25 percent (or increase of 1.5 percent of GDP). Much of this revenue growth is set to come from indirect tax collection (trade taxes and vat). As indirect taxes are on consumption and imports, the revenue structure is becoming increasingly dependent on remittances as well. Indirect taxes are approximately 50 percent of total tax revenue, which lowers progressiveness of the tax system. As part of its effort to meet the high FY10 revenue target, the government has raised some indirect tax rates (mostly excises), increased reliance on dividends (service sector), and announced more sales of public assets.

Box 1: Budget Implementation

Budgetary concerns include the following: (i) size—it is expansionary; (ii) composition—recurrent expenditures are increasing and capital formation is very low; and (iii) implementation capacity—especially with the deteriorating law and order situation and late approval of annual plans. On average, 15 percent of capital expenditure and 10 percent of recurrent expenditure were unspent between FY03 and FY 09. Estimated capital expenditure in FY 09 is only 70 percent of the budgeted capital allocation.

Cognizant of cost from bunching of expenditure in the last trimester, the government announced, for the first time, many measures in the FY10 Budget to improve its implementation. Major policy announcements included: (i) multi-year contracting for priority projects—to enhance budget predictability; (ii) third quarter fund virement from low spending activities to performing projects—to strengthen performance- based allocations; (iii) multi-location tender-document submission, including e-tenders—to mitigate the current situation in which tendering processes are disrupted at local levels; and, (iv) a list of 36 core monitorable indicators in 11 sectors drawn from annual plans—to enhance accountability and link strategy to outputs and outputs to budget.



1995, the external debt stock dropped by about 17 percentage points of GDP from 2001 to 2007, as a result of relatively low external loan disbursements and the appreciation of the Nepalese rupee. The domestic debt stock accounts for around 14 percent of GDP and constitutes an increasing share of total public debt.

GDP projections

Growth is projected to range between 4 percent and 6 percent.

With political uncertainties and limited information that can be used for projection, the possible growth range is wide in the medium term, but immediate

growth may be constrained to lower ends of the range (see table). Agricultural dependence on rainfall also increases uncertainties. The current government aims to achieve 5.5 percent growth this year. To achieve

GDP Growth Rate					
		Est.	Projection		
2007	2008	2009	2010	2011	2012
					4.5-

and sustain this level of growth, a higher level of private and public investment is needed. But, as the government itself recognizes, downside risks are significant given political uncertainty.

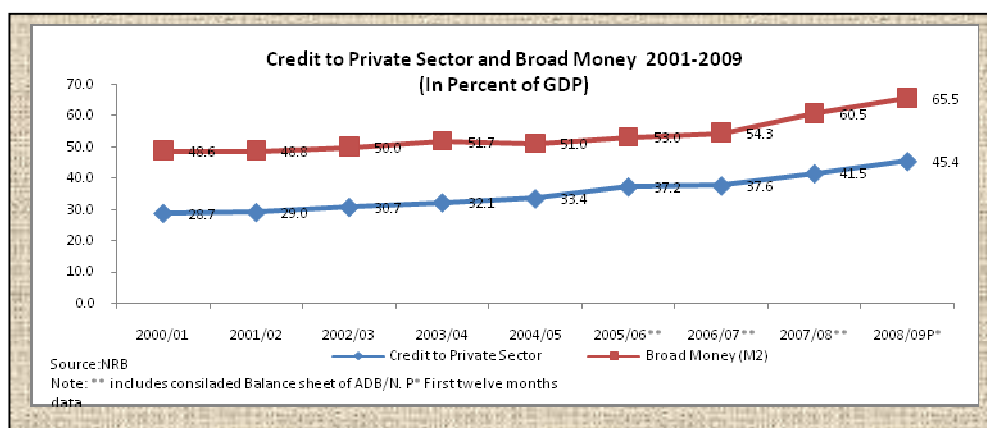
Monetary Policy

The Nepal Rastra Bank—the central bank—characterized its monetary policy for FY10 as “cautious and tight” on July 24th. This had been the stated approach also in FY09; nevertheless, the monetary policy in FY09 was broadly expansionary, mainly owing to NRB’s intervention in the foreign-exchange market. The Nepal Rastra Bank stated the need to guard against bubbles in real estate and the stock market to prevent further inflationary pressures and has set a target growth rate for broad money supply (M2) of 17% in FY10 (FY09 M2 growth is estimated to be 21%) , and the target for average inflation at 7% in FY10.

It has been challenging to design monetary policy to contain inflation. In order to tighten monetary conditions, during FY09, open market operations were used to absorb liquidity of NRs 9.72 billion (7 percent of the increase in M2) as opposed to NRs 1.2 billion in FY08. In addition, the existing bank rate was raised in FY09 from 6.25 percent to 6.50 percent, and the mandatory Cash Reserve Ratio was raised from 5.0 to 5.5 percent. The penal rate for the Standing Liquidity Facility was also raised from 2.0 percent to 3.0 percent. At the same time, to enhance export competitiveness, the refinancing rate for export credit was lowered from 2.5 to 2.0 percent, and to widen fiscal inclusiveness, the compulsory obligation for commercial banks to issue 3.0 percent of total credit for the poor is maintained. A similar obligation increased for development banks from 1.0 to 1.5 percent and a 1.0 percent obligation was set up anew for financing companies.

In addition, to reduce the financial sector’s exposure to margin lending and lending into real asset speculation, the Nepal Rastra Bank took administrative measures. The central bank instituted ‘prompt corrective action’ and started to use ‘long audit form’ to monitor banks’ action carefully. Another measure the Rastra Bank recently took was to freeze issuing new banking licenses so that the licensing policy could be reviewed. This was because applications to establish new banks had been approved without exception, and the number of commercial banks had increased to 26 from 20, and the number of development banks from 38 to 61 over the last two years.⁵ Some of the new institutions have adopted a policy of high risk-taking in both deposit collection and lending, pushing existing banks to do the same to remain competitive.

Despite these measures to tighten monetary conditions, monetary aggregates have kept growing; broad money increased by 27 percent during FY09 supported by both increased foreign assets (on account of remittance inflows) and increased claims on the private sector. In FY08, money

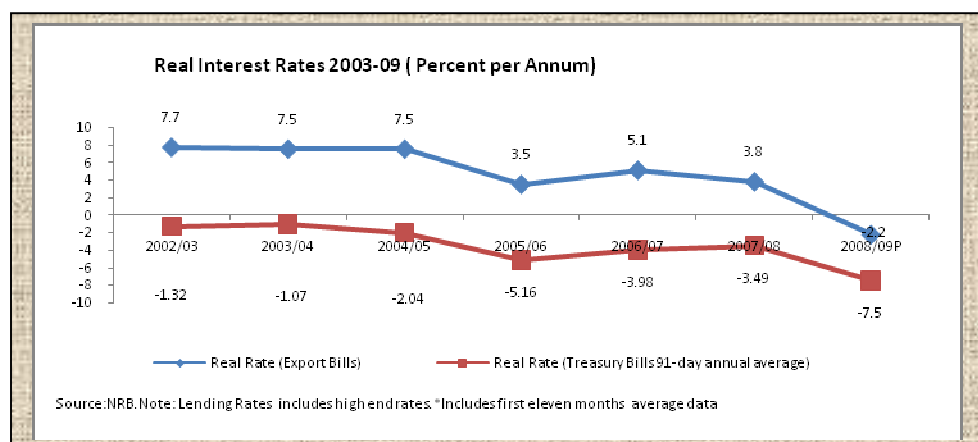


growth was 25 percent, and in these two fiscal years, money velocity declined by nearly 20 percent. If this change in velocity is not based on increased money demand, inflationary pressure may remain. Commercial bank deposits are rising by 32 percent a year mostly due to remittance flows. Credit to the private sector, as a result, increased by 28 percent in FY09 (24 percent in FY08).

⁵ Registered banks are now 28 institutions with two banks’ applications pending.

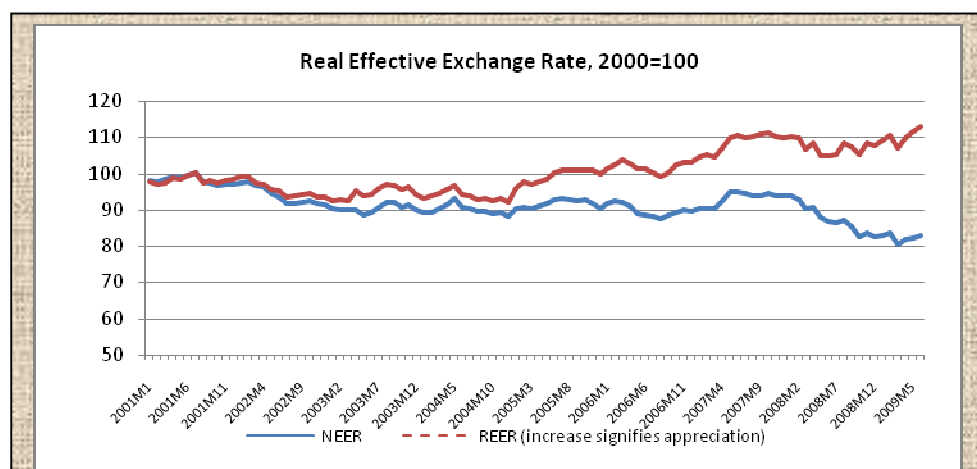
Key interest rates remain negative or very low in real terms, due to high liquidity in the economy. Of the private sector credit extended by commercial banks, a large portion goes to finance real estate (14.7 percent of the FY09 increase), wholesale and retail (13.7 percent), and construction (13.3 percent).

Consumer loans, which used to be insignificant, comprised 5.5 percent of the increased credit in FY09. Credits to the productive sectors also went up, comprising 13.6 percent of the total credit extension. Loans to agriculture, mining, and tourism were all negative (net amortization). These indicate that much of the funds that enter the country in the form of remittances are financing consumption and investment in the real estate sector – a sign of “Dutch disease”.



The exchange rate peg to the Indian rupee, in place since 1993, has been maintained. In recent years the peg has provided stability to the monetary sector and helped anchor inflation - particularly useful given an environment where resources and capacity to effectively manage a flexible rate are still limited. The peg has also been appropriate given the high and increasing intensity of economic activity between the two countries; more than 64 percent of Nepal’s recorded total trade is with India. Furthermore, it has helped maintain macroeconomic discipline in line with India. But as the Indian economy continues to grow at a much faster rate than that of Nepal, with external and domestic shocks, these two economies may become more divergent, the peg system may need to be reassessed.

The real exchange rate has appreciated by about 11.5 percent in the past three years, partly driven by the decline of the US dollar against the Indian rupee⁶. From April to June 2009, the REER appreciation has been 5.4 percent.



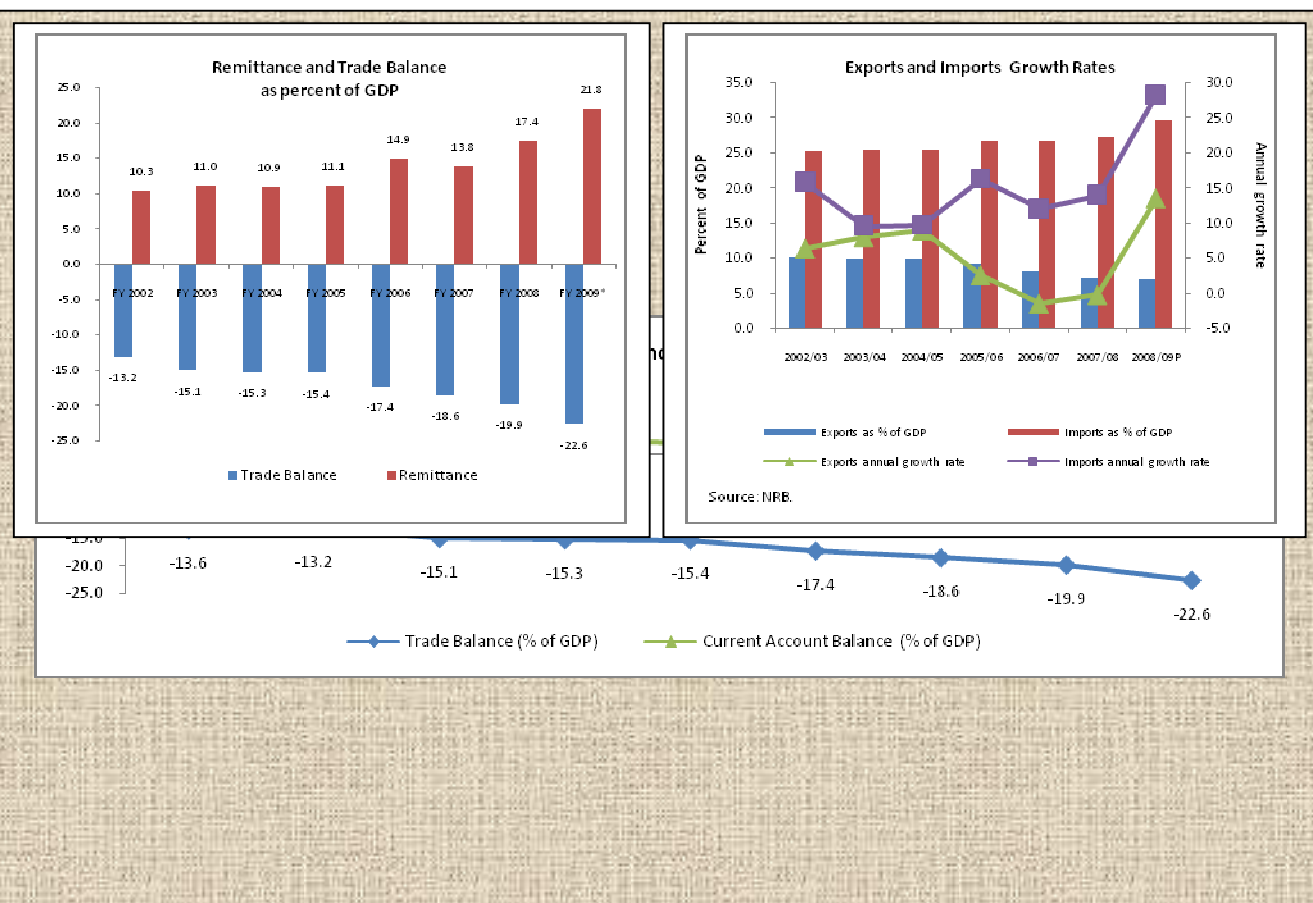
⁶ It has to be noted that the REER measured here uses trade weights that may understate the current share of Nepal’s trade with India. In addition, a better REER may be that of wage-weighted or one based on relative prices of tradable and non-tradable prices. But data limitations are the constraint.

External Sector

Nepal's trade deficits are large while the current account has been in surplus. The trade deficit increased by 1.2 percentage points of GDP per annum from FY 02 to FY 09 – to the current 23 percent. Exports are growing slowly, 2.8 percent a year. Because of a narrow export base, changing global demand, removal of most-favored-nation status, and the global financial crisis, exports now represent only 7 percent of GDP. Imports have grown rapidly fueled by remittance-led consumption. This large trade deficit is more than offset by remittances and the current account has been in surplus. With large numbers of migrant workers leaving the country, this trend will likely continue.

India is the single-largest trading partner of Nepal, accounting for 64 percent of Nepal's total trade; and widening bilateral trade deficit is a concern. Remittance-led domestic consumption has increased imports from India while Nepal's exports trade competitiveness in relation to India has declined. The latter is due to several factors: non-tariff barriers, a reduction in Nepal's tariff status in India, erosion in the popular preference for Nepalese goods versus those of other countries, the narrow spread of exportable products to India and additional duties on exports from Nepal. To furnish import bills, Nepal purchased India currency worth of US \$ 1.7 billion in FY 08 and US \$ 1.5 billion in FY 09.

In FY09, the current account recorded a surplus of Rs. 41.4 billion (4.3 percent of GDP), up from the Rs. 23.7 billion (3.6 percent of GDP) surplus recorded in FY08. The high current account surpluses of recent years are due largely to the high net transfers (37 percent increase) channeled by worker's remittances (47 percent rise in FY09 from the previous year) despite a deteriorating balance of trade in goods. The current level of reserves is adequate to finance merchandise imports of 11.8 months.



Vulnerabilities and Risks

Box 2: Nepal's Exports

To India- diversified but the exports can be subject to non-tariff barriers Indian authorities, especially State Governments, impose (e.g., ghee, but see the box on the new trade treaty with India).

To other countries- mainly three items: pashmina, readymade garments, and carpets. Handicraft and herb exports are also increasing but from small base. These exports tend to be for specific markets (Europe and/or USA) and are subject to demand fluctuations in these countries. Also readymade garment exports halved after the lapse of Multi Fiber Agreement in 2004/05.

Re-exports: Often smuggled goods can be exported. Exports of pulses in FY09 (a quarter of third country exports) were largely in this category and careful assessment of trade data needed.

Nepal is vulnerable to several challenges and risks: Nepal's economy is highly dependent on remittances, and its exports and tourism may be affected by fluctuations in global economic activities. So far the impact of the global financial crisis has been much less than feared — but risks remain especially if global recovery is slow. Adverse effects could creep in, and if combined with domestic political uncertainties, the impact could further heighten political tensions. In addition, the financial sector's exposure to speculative investor behavior in the real estate sector poses immediate risk to the sector.

Remittances: Migrant workers are now estimated to comprise more than one third of the male population and female migrants are increasing. These workers go mostly to four countries: Qatar, Saudi Arabia, the United Arab Emirates and Malaysia; and, last year, sent back remittances estimated to amount to around 30 percent of GDP (see "Topic for Discussion", below, for details). These remittances have raised household expenditure significantly and reduced poverty. Such heavy dependence on one source of foreign currency earning is risky; its slow-down or reversal could create a heavy burden for Nepal.

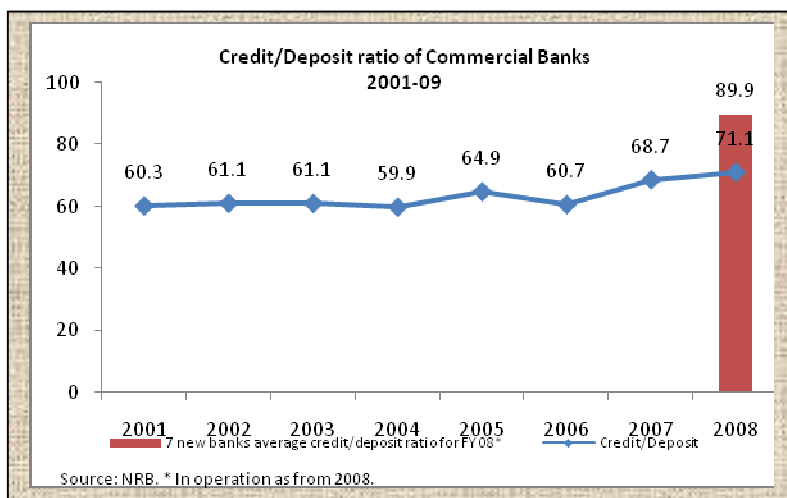
Tourism : Tourism could also be affected adversely by economic slowdown in origin countries. During FY09, when the world was experiencing a severe recession, the number of arrivals by air declined, but, only by 2 percent relative to FY 08, which had been a good year. It seems that the higher end tourism would be affected more than the budget travelers and trekkers.

Exports : Exports have been anemic for some time. Exports to countries other than India increased by 7 percent in FY 09. Much of this increase was due to re-exports of Indian goods to Bangladesh (pulses, wheat). Pashmina exports to Europe and the United States increased but, from a very low level. Adjusting for the re-exports, exports to non-Indian countries appear stable, from previous year, in dollar terms. Exports to India increased by 10 percent in Nepal Rupee terms (which is pegged to the Indian Currency) — but, if inflation is taken into account, exports were much the same, in real terms, as those of previous year. The story appears similar to those of remittances and tourism—each has been adversely affected, but not seriously. The situation could worsen, however, if the global recession is prolonged.

Nepal's import elasticity with respect to Gross National Disposable Income (approximately GDP plus remittances) is about 1.3, but this elasticity has been rising. It is expected that slowdown in remittance flows will automatically reduce imports. Because today's imports of a high number of vehicles, for example, would create future recurrent demand for oil product imports, Nepal would be increasingly vulnerable to deteriorated terms of trade.

Financial Sector: The financial sector (both banking and non-banking financial institutions such as financing companies) appears vulnerable to high speculative exposure to real estate. A proliferation of institutions may also pose risks, because many smaller institutions take risky positions and adopt aggressive deposit-mobilization and lending strategies. Some newer banks appear to have high credit-to-deposit ratios as well as high exposure to real asset lending. The Nepal Rastra Bank's

efforts to contain the sector's exposure to risky lending are hampered because of its limited supervision capacity—especially regarding non-commercial bank institutions.



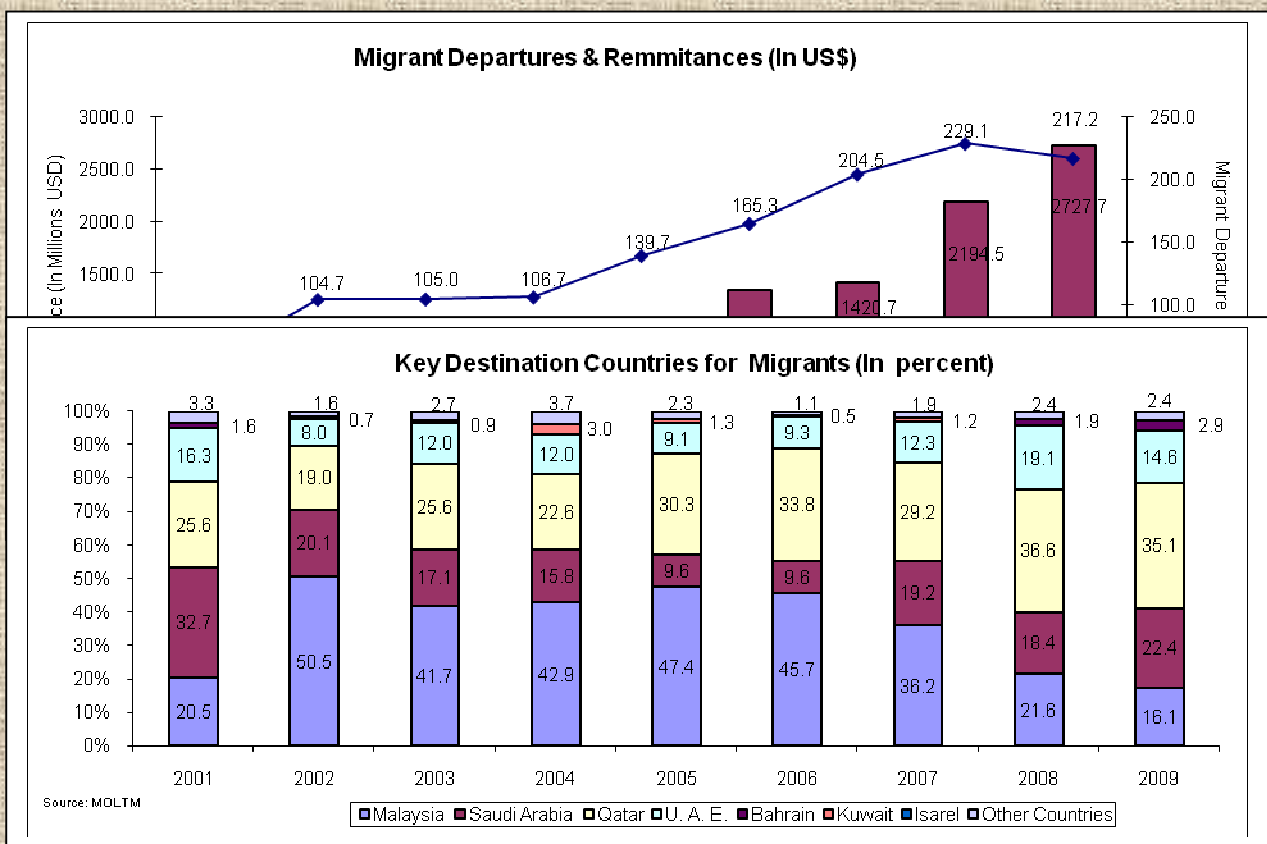
Increased land values have also contributed to lowering of non-performing loans (NPLs), but this improvement could be reversed if land prices decline rapidly. Higher value of collateral (land) improved the loan quality and made it easier for defaulters to restructure their loans. The gross NPLs thus came down to single digits for the first time in 2008, reaching 6.1 percent, from as high as 30.4 percent in 2002. This declined further to 5.4 percent by mid-January 2009—again, due mainly to the soaring land prices. The profitability of the banking sector, therefore, rose in 2008, with returns on assets registering 2.8 percent, the highest in South Asia. The capital adequacy ratio also turned positive for the first time and stood at 4.04 percent in 2008; though far below, the regulatory capital requirement of 11 percent mandated by the Nepal Rastra Bank. As all these improvements depend much upon higher collateral value, continued careful supervision by the Rastra Bank of the financial sector remains important.

Topic for Discussion

International Migration and Remittances: Their Impact and Macroeconomic Policy

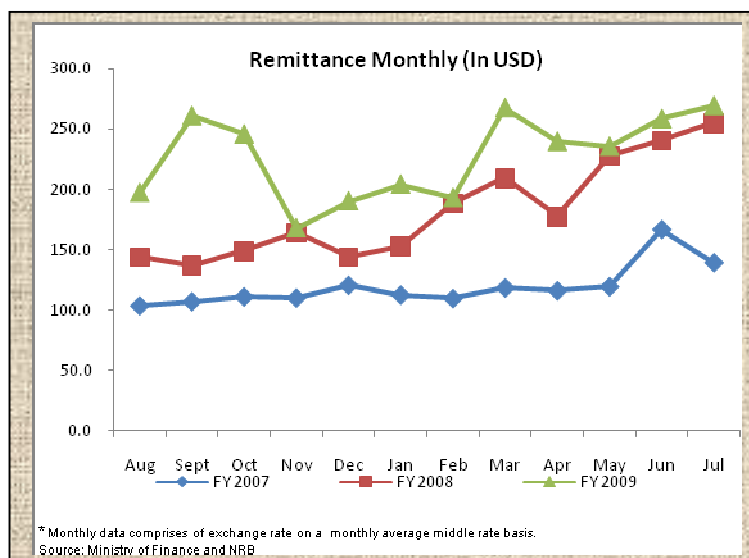
Migration Flows

International migration has always been part of Nepali life, with many having migrated seasonally to India throughout history. But the number of workers leaving the country started to rise rapidly with the intensified civil insurgency in 2001/02. Many young men left rural areas in part to avoid fighting and conscription by fighting forces—and looked for employment elsewhere. With domestic job creation limited, they naturally turned to foreign employment. Nowadays, it is estimated that more than one-third of the male population, or above 4 million, are outside the country⁷. Aside from India, four countries, Malaysia, Qatar, Saudi Arabia, and the U.A.E. are primary destinations for Nepalese workers; and, every year 96 percent of departing workers head for one of these four countries.



Migrant workers, while abroad, remit money back to their families in Nepal. The officially recorded inward remittances from countries other than India amounted to \$2.7 billion during FY09 — up from \$2.2 billion in FY08. This would be 22 percent of FY09 GDP. But, since this number excludes almost all remittances from India (and those flows using informal channels that are not reported to the Nepal Rastra Bank), it is estimated that total value of remittances into the country can approach 30 percent of GDP. Remittances have become by far the largest source of foreign currency earnings—far exceeding exports, official aid, and tourist receipts. It is recognized, however, that non-trivial though unknown amounts are being paid by Nepalese recruiting agencies to destination-country agencies as often-illegal commission fees.

Remittances have become increasingly important for households over the last decade. It is estimated that one in every three households is receiving some form of international remittances. Poverty declined from 42 percent to 31 percent between FY97 and FY04



(the two years when the National Living Standard Surveys were carried out). It is estimated that half of the decline in poverty incidence was attributable to remittances. Given the huge increase in remittances from FY04, it is believed that poverty incidence has gone down even further.

Gains and Costs of High Rates of Migration and Remittances

Gains

An obvious gain from the high remittances is that household incomes increased and many have escaped poverty. Per capita expenditure rose by 42 percent in real terms, while real GDP per capita increased by only 13 percent between FY97 and FY04. Spending increased more than income largely because of remittances. Most of the increased expenditure went to consumption. When households receiving remittances invested the resources, they invested in children's education or in real estate. A new NLSS is currently being conducted and more up-to-date information should be available soon.

Real wages have increased. Agricultural real wages rose by 25 percent in real terms between the two NLSSs – 1997-2004. Non-agricultural real wages increased by 20 percent and skill-wages in real terms tripled in the same period. The Labor Force Survey 2008 also indicates that salaries of paid workers increased by nearly 40 percent in real terms over the last decade. Recent wage data also reveal that while all types of wages are rising faster than inflation, wage hikes are particularly high for agricultural workers and construction workers. Among the forces contributing to higher real wages is the sheer size of outward migration that has reduced the size of the workforce, especially in rural areas. Also, the increased household income enables more

potential workers to withdraw from the workforce in favor of leisure. However, the demand for consumption goods, including food, keeps rising, pushing up both rural wages and food prices. The higher wages should give workers an increased incentive to work longer hours —but this incentive does not appear to offset the income effect.

The same logic applies to urban wages, particularly, in the construction sector. The increased demand for housing and real estate has boosted demand for new construction, causing housing and land prices to rise and hence the wages of construction workers. There are concerns, about what many see as real estate bubble; careful and painful policies may be needed to engineer a soft-landing.

Increased income inequality is another result of the remittance effect. The Gini coefficient – a measure of income inequality - rose from 34.2 percent to 41.4 percent between the two NLSS periods. The analysis shows that the inequality came from a dramatic increase in higher education and skills — and nobody is made worse off. In other words, goods and services that are increasingly in demand appear to be more skills - intensive. This encourages labor utilization and provides incentives for workers to acquire more skills.

Costs

Macroeconomic or economy-wide costs of high remittances could be categorized into two areas:

- (i) The economy's dependence on remittances means high vulnerability to slowdown or reversal (as feared in the current crisis); and
- (ii) Macroeconomic management, competitiveness, and future growth all tend to suffer.

Vulnerability

Dependence on remittances at this high level increases the economy's vulnerability to their slowdown or reversal. But it seems Nepal has been relatively fortunate that its migrant-destination countries were not too badly affected by the global recession. Also, Nepalese worker-quotas in Saudi Arabia and Qatar have recently been increased. These destination countries' public investment programs continued relatively unscathed. Malaysia also re-relaxed immigration controls on Nepalese workers, and, other destination countries are emerging. Nepalese workers also tend to have rather diverse job-skills (not limited to construction and manufacturing) and thus may be more resilient to shocks (ILO). Because of these factors, the stock of Nepalese workers abroad has continued to increase; even through the daily departure rate of migrants fell last year, it still surpassed the daily rate of returning workers. As a result, remittances in FY09 increased by 24.3 percent in dollar term - a higher rate of growth than for any other country in the region and higher than predicted.

There is still a risk that a slow or W-shaped recovery worldwide could reduce remittances and daily net migration. Nevertheless, the probability of Nepal suffering from a large and sudden decline should be small in the near future as remittances depend on the large stock of existing migrants. . A World Bank task team has calculated that even if the global crisis were to have a severe effect on Nepal's remittances, these would decline by only 2-4 percent. This would mean a reduction of US\$40- 100 million out of more than US\$2 billion. If this were to happen, imports would also decline so having limited impact on the country's balance of payment. Some households would suffer from reduced remittances, but, the economy, as a whole, should be able to absorb this scale of reduction considering it has US\$3.6 billion foreign reserves. Furthermore,

if this marginal decline were to take place, it could help to calm the real estate market, and soft-land the bubble.

Another possible consequence of a prolonged crisis or W-shaped recovery would be a decline in net outward-migration. Unlike a reduction in remittances, this could cause serious political tension. If any major destination country were to stop replacing returnees with new recruits, or worse, send back existing workers prematurely, it would create strong labor-market pressure in Nepal. In an economy, where 300,000-400,000 people enter the labor market every year and private jobs are not being created (young urban unemployed are highly frustrated), any news of migrants being unable to leave or forced to return would raise prospects of social unrest.

The government needs to encourage a business environment conducive to private investment so as to create more jobs in the medium term. Also, to enhance immediate job creation, the government should pursue policies that accelerate existing public investment and labor-intensive maintenance work that are labor intensive, or start additional and high priority labor intensive public works programs or institute targeted fiscally sustainable programs for the vulnerable. The success of the latter program would depend on the government's capacity to implement and the reservation wages of returning migrants.

Macroeconomic Management Difficulties

At first sight, remittance appears beneficial for macroeconomic management. They will likely improve fiscal revenue through increased collection of import tariff and value added tax on consumption goods, and improve debt and fiscal sustainability. Because remittances are steady and countercyclical, they are also expected to reduce income volatility. However, the often-quoted problem of large remittances is the appreciated real exchange rate and associated loss of export competitiveness—that could push down long-term growth. This is one of the largest challenges policy makers face.

With real exchange appreciation and associated wage increases, external competitiveness suffers, exports decline and at the same time the price structure reduces incentives to invest in tradable sectors and shrinks the future tradable production base (thus the economy would become more vulnerable to future BOP shocks). It could reduce the rate of capital accumulation, and likely slow future growth (although empirical evidence is mixed). In many countries, total factor productivity also declined with remittances. It takes more data and intensive analyses of these data to assess if these adverse effects are in fact taking place.

